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SIPDIS

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SUBJECT: 2007 BUDGET PASSES EASILY AMID GROWING SCANDALS AT
THE MOF

REF: TEL AVIV 0036

CLASSIFIED BY: DCM GENE A. CRETZ FOR REASONS 1.4 (B) AND (D)

11. (C) SUMMARY: THE 2007 BUDGET, TOTALING NIS 283 BILLION (USD 67 BILLION), BREEZED THROUGH THE KNESSET ON JANUARY 4, AFTER THE PARTIES IN THE GOVERNING COALITION DROPPED THEIR DEMANDS FOR ADDITIONAL SPENDING. THE BUDGET MAINTAINS THE GOI POLICY OF FISCAL RESTRAINT, EVEN WITH THE LARGER THAN EXPECTED ALLOCATION OF USD 12.5 BILLION FOR DEFENSE-RELATED EXPENDITURES. CRITICS CLAIM, HOWEVER, THAT IT DOES NOTHING TO NARROW THE GROWING GAP BETWEEN THE RICH AND THE POOR, AND EVEN CUTS SOCIAL WELFARE SPENDING TO PAY FOR THE DEFENSE EXPENDITURES. THE BUDGET PASSED ONLY HOURS BEFORE REPORTS HIT THE PRESS ABOUT THE EMERGENCE OF A MAJOR SCANDAL INVOLVING THE ISRAEL TAX AUTHORITY (ITA), AND ANOTHER PRESS STORY THE NEXT DAY INDICATING THAT FINANCE MINISTER HIRCHSON IS PERSONALLY IMPLICATED IN THE POLICE INVESTIGATION OF A DIFFERENT SCANDAL INVOLVING EMBEZZLEMENT AND THEFT FROM THE PERIOD BEFORE HE BECAME A GOVERNMENT MINISTER. THE PRIME MINISTER (PM) AND FINANCE MINISTER (MINFIN) PREVAILED UPON DEPARTING MOF DIRECTOR GENERAL YOSHI BACHAR TO TEMPORARILY ASSUME CONTROL OF THE ITA IN ORDER TO RESTORE A SENSE OF PROPER FUNCTIONING TO THE ORGANIZATION. HOWEVER, BACHAR'S DEPARTURE AS DG, TOGETHER WITH THE SUDDEN ERUPTION OF MOF SCANDALS POSSIBLY INVOLVING HIRCHSON AND ELEMENTS IN THE PRIME MINISTERS OFFICE, PRESAGES INSTABILITY FOR ISRAELI ECONOMIC POLICY IN THE IMMEDIATE FUTURE. PRESS REPORTS ALREADY SPEAK OF A POSSIBLE LOSS OF INVESTOR CONFIDENCE IN ISRAEL AS A RESULT OF THE SCANDALS. END SUMMARY.

BUDGET BREEZES THROUGH THE KNESSET

12. (U) IN LINE WITH FINANCE MINISTER AVRAHAM HIRCHSON'S STATED GOAL OF SECURING THE BUDGET'S APPROVAL BY THE START OF THE NEW YEAR, THE KNESSET PASSED THE 2007 BUDGET BILL JUST AFTER MIDNIGHT ON THE MORNING OF JANUARY 4, REPRESENTING A DEPARTURE FROM PAST YEARS, WHEN THE BUDGET APPROVAL PROCESS FACED SIGNIFICANT DELAYS. MINFIN HIRCHSON WAS ADAMANT ABOUT "MAINTAINING THE BUDGET FRAMEWORK" AND FISCAL RESTRAINT. ALTHOUGH SOME COALITION PARTNERS HAD EARLIER DEMANDED HUGE ADDITIONAL ALLOCATIONS RANGING UP TO NIS 6 BILLION (USD 1.4 BILLION) IN RETURN FOR THEIR SUPPORT ON THE VOTE, THEY ULTIMATELY DROPPED THESE DEMANDS FOR FEAR OF FORCING EARLY ELECTIONS IN WHICH MANY OF THEIR MEMBERS WOULD FACE THE PROSPECT OF LOSING THEIR KNESSET SEATS. THE BUDGET PASSED BY

A 63 TO 31 MARGIN, WITH SIX ABSTENTIONS.

13. (U) VARIOUS PARTIES, BOTH WITHIN AND OUTSIDE THE COALITION, WERE, HOWEVER, REWARDED FOR THEIR SUPPORT. FOR EXAMPLE, AVIGDOR LIEBERMAN'S ISRAEL BEITENU PARTY RECEIVED APPROXIMATELY NIS 190 MILLION (USD 45 MILLION), INCLUDING MONEY FOR SURVIVORS OF THE HOLOCAUST, DISCHARGED SOLDIERS, COMBATING THE DRUG TRADE, AND TAX BENEFITS FOR THE ELDERLY AND NEW IMMIGRANTS. THE OPPOSITION UNITED TORAH JUDAISM (UTJ) FACTION, WHICH HOLDS THE CHAIR OF THE FINANCE COMMITTEE, WILL RECEIVE NIS 290 MILLION (USD 69 MILLION) FOR ULTRA-ORTHODOX HAREDI SCHOOLS AS PAYMENT FOR ABSTAINING IN THE BUDGET VOTE -- IN ADDITION TO THE NIS 290 MILLION IT ALREADY RECEIVED FOR ABSTAINING ON THE FIRST READING OF THE BUDGET LAW IN SEPTEMBER. MOREOVER, UTJ FINANCE COMMITTEE CHAIR, YACKOV LINTZMAN, REPORTEDLY WORKED HARD TO FACILITATE THE BUDGETS SMOOTH APPROVAL. AT THE JANUARY 7 CABINET MEETING, A MAJORITY (THIRTEEN) OF MINISTERS SUPPORTED THE PRIME MINISTER IN FURTHER CUTTING SPENDING BY NIS 870 MILLION (USD 208 MILLION) TO SOMEWHAT OFFSET THE NIS 1.85 BILLION (USD 443 MILLION) ADDED TO THE DEFENSE BUDGET SEVERAL WEEKS AGO. THE SPENDING REDUCTION INVOLVES AN ACROSS-THE-BOARD CUT IN THE ACQUISITION BUDGETS FOR MOST MINISTRIES OF ABOUT 3.5 PERCENT.

SCANDALS AROUND IN THE MOF

14. (C) THE DAY THAT THE BUDGET BILL PASSED WAS ALSO MARKED BY THE EMERGENCE HOURS LATER OF ALLEGATIONS REGARDING IMPROPRIETIES IN THE ISRAEL TAX AUTHORITY (ITA), A DIVISION OF THE MINISTRY OF FINANCE (SEE REFTTEL). POLICE ALLEGE THAT TOP ITA AND OTHER GOVERNMENT OFFICIALS HAD EITHER RECEIVED OR GIVEN BRIBES TO WIN TAX BREAKS FOR COMPANIES, AMONG OTHER

IMPROPRIETIES. SHULA ZAKEN, PRIME MINISTER OLMERT'S PERSONAL SECRETARY, AND ABOUT 30 OTHERS, INCLUDING SENIOR OFFICIALS,

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ARE BEING INVESTIGATED AS PART OF THE CASE, INCLUDING JACKY MATZA, THE HEAD OF THE ITA, AND HIS IMMEDIATE PREDECESSOR IN THE JOB, EITAN RUB. BOTH PM OLMERT AND MINFIN HIRCHSON MAY BE QUESTIONED BY THE POLICE IN CONNECTION WITH THE CASE. THE SCANDAL HAS SPARKED OUTRAGE WITHIN ISRAELI SOCIETY AND EXACERBATED THE PUBLIC'S DISTRUST OF GOVERNMENT THAT HAS GROWN SINCE THE SUMMER'S INCONCLUSIVE WAR IN LEBANON AND A RASH OF OTHER SCANDALS INVOLVING ISRAELI POLITICAL FIGURES. BOTH PM OLMERT AND MINFIN HIRCHSON CONVINCED OUTGOING AND WELL-RESPECTED MOF DG YOSHI BACHAR TO ASSUME THE HELM OF THE ITA TEMPORARILY TO RESTORE ORDER AND CONFIDENCE TO THAT ORGANIZATION, AND TO MAINTAIN BACHAR'S CALMING PRESENCE AT THE MOF. FURTHER DAMAGING THE MOF HAVE BEEN REPORTS, INITIALLY PUBLICIZED THE MORNING AFTER THE BUDGET'S APPROVAL, THAT MINFIN HIRCHSON HIMSELF IS SUSPECTED OF FRAUD, MONEY LAUNDERING, AND INVOLVEMENT IN THE THEFT OF MORE THAN NIS 5 MILLION (USD 1.2 MILLION) FROM THE NATIONAL WORKERS UNION (A PART OF THE HISTADRUT FEDERATION OF TRADE UNIONS), WHICH HE HEADED PRIOR TO BECOMING A GOVERNMENT MINISTER. IN THE DAYS SINCE THE SMOOTH APPROVAL OF THE BUDGET, HIRCHSON HAS TRIED TO PROJECT A "BUSINESS AS USUAL" ATTITUDE, DESPITE THE SCANDALS.

SNAPSHOT OF THE 2007 BUDGET

15. (U) ISRAEL'S 2007 STATE BUDGET TOTALS APPROXIMATELY NIS 283 BILLION (USD 67 BILLION) AND REPRESENTS YEAR-ON-YEAR REAL EXPENDITURE GROWTH OF ABOUT 3.3 PERCENT OVER 2006, CONSISTING OF THE 1.7 PERCENT SPENDING INCREASE ALLOWED FOR IN THE COALITION AGREEMENTS, PLUS A ONE-TIME ADDITIONAL 1.6 PERCENT (NIS 3.5 BILLION OR USD 830 MILLION) INCREASE EARMARKED FOR FINANCING EXPENSES RELATED TO THE LEBANON CONFLICT. IN ADDITION, THE GOVERNMENT PLANS AN ADDITIONAL 0.5 PERCENT (NIS 1.1 BILLION OR USD 26 MILLION) OFF-BUDGET SPENDING INCREASE TO FUND CONTINUING DISENGAGEMENT-RELATED EXPENSES. THE

DEFICIT TARGET WILL BE 2.9 PERCENT OF GDP, OR NIS 18.7 BILLION (USD 4.4 BILLION). TAX REVENUES ARE FORECASTED TO BE LOWER THAN IN 2006, DURING WHICH THERE WERE ONE-TIME RECEIPTS TOTALING APPROXIMATELY NIS 6 BILLION (USD 1.4 BILLION) -- USD 1 BILLION OF WHICH ALONE RESULTED FROM WARREN BUFFETS PURCHASE OF 80 PERCENT OF THE ISRAELI COMPANY ISCAR FOR USD 4 BILLION IN CASH. THE NEXT PHASE OF THE INCOME AND CORPORATE TAX REDUCTIONS RESULTING FROM THE GOVERNMENT'S TAX-REFORM PROGRAM WILL GO INTO EFFECT IN JANUARY 2007, AND WILL LIKELY REDUCE TAX REVENUES IN THE FUTURE.

A GENERAL BREAKDOWN OF THE MAJOR BUDGET CATEGORIES FOLLOWS:

- 18.6 PERCENT (USD 12.5 BILLION) FOR DEFENSE EXPENDITURES;
- 29.9 PERCENT (USD 20 BILLION) FOR DEBT REPAYMENT;
- 29.4 PERCENT (USD 19.7 BILLION) FOR TRANSFER PAYMENTS AND SUPPORT;
- 4.1 PERCENT (USD 2.7 BILLION) FOR INVESTMENT AND CREDIT;
- 17.1 PERCENT (USD 11.5 BILLION) FOR OTHER CIVILIAN EXPENDITURES.

16. (U) AMONG THE GOI MINISTRIES, THE DEFENSE MINISTRY RECEIVED NIS 47.8 BILLION (JUST OVER USD 11 BILLION) -- THE LARGEST SLICE OF THE BUDGET -- WHILE THE SHARE FOR THE EDUCATION AND HEALTH MINISTRIES AMOUNTED TO NIS 25.9 BILLION (USD 6.2 BILLION) AND NIS 16.1 BILLION (USD 3.8 BILLION), RESPECTIVELY. JUST ONE YEAR AGO, THE ECONOMIC CAMPAIGN PROPOSALS PUT FORTH BY THE LABOR PARTY IN THE RUN UP TO THE NATIONAL ELECTION CALLED FOR REDUCING DEFENSE SPENDING IN FAVOR OF SOCIAL WELFARE SPENDING. IN THE WAKE OF THE WAR IN LEBANON, THE COMPETITION BETWEEN THE DEFENSE ESTABLISHMENT AND SOCIAL NEEDS CONTINUES, WITH DEFENSE EMERGING AS THE CLEAR WINNER. IN THE 2007 BUDGET, NATIONAL INSURANCE BENEFITS ARE TO BE CUT BY FOUR PERCENT, THE THIRD STAGE IN THE INCREASE IN THE MINIMUM WAGE IS TO BE DELAYED, AND THE AGE AT WHICH PEOPLE ARE ENTITLED TO CLAIM UNEMPLOYMENT COMPENSATION WILL REMAIN 28, DESPITE EFFORTS TO HAVE IT REDUCED TO 25.

17. (U) DR. MICHAEL SORREL, HEAD OF THE ECONOMICS AND RESEARCH DIVISION OF HAREL INSURANCE AND FINANCE, AND FORMER HEAD OF RESEARCH AT THE FINANCE MINISTRY, NOTED IN A MACRO-ECONOMIC REPORT DATED JANUARY 4 THAT THE BUDGET BROADCASTS THE MESSAGE OF CONTINUED FISCAL STABILITY. HE

ADDED THAT EVEN WITH THE INCREASE IN DEFENSE EXPENDITURES AND OTHER SPECIAL SPENDING IN LIGHT OF THE WAR IN LEBANON, THERE WOULD BE A DECLINE IN GOVERNMENT EXPENDITURES AS A PERCENTAGE OF GDP IN 2007 IF GROWTH CONTINUES AT A REASONABLE RATE -- AS HE EXPECTS.

COMMENT

18. (C) ISRAEL IS IN THE PECULIAR SITUATION OF EXPERIENCING ECONOMIC PROSPERITY UNPARALLELED IN ITS SHORT HISTORY, WHILE AT THE SAME TIME FACING A SEVERE LOSS OF PUBLIC CONFIDENCE IN THE FUNCTIONING OF ITS GOVERNMENT, SPARKED BY THE LACKLUSTER PERFORMANCE IN THE LEBANON WAR AND EXACERBATED BY THE UNFOLDING SCANDALS INVOLVING HIGH OFFICIALS IN THE MOF AND THE PRIME MINISTER'S OFFICE -- AS WELL AS THE SCANDALS ENVELOPING THE PRESIDENT AND THE FORMER MINISTERS OF JUSTICE AND PUBLIC SECURITY. THERE HAVE EVEN BEEN RUMBLINGS IN THE PRESS ABOUT THE POSSIBLE LOSS OF CONFIDENCE BY INVESTORS IN THE ISRAELI ECONOMY. SOME ISRAELI OFFICIALS HAVE TOLD REPORTERS THAT THE SCANDALS MAY BLACKEN ISRAEL'S IMAGE ENOUGH TO DISCOURAGE BOOMING FOREIGN DIRECT INVESTMENT, WHICH TOTALED USD 13.2 BILLION IN 2006 VERSUS 5.6 BILLION IN 2005 AND 1.7 BILLION IN 2004.

19. (C) COMMENT CONTINUED: THE MORALE OF THE FINANCE MINISTRY HAS BEEN DEVASTATED, WHICH DOES NOT BODE WELL FOR THE MAINTENANCE OF FISCAL DISCIPLINE IN THE LONG RUN. WITH THE MINISTER PERSONALLY IMPLICATED IN CORRUPTION ALLEGATIONS, THE RESPECTED BACHAR LEAVING HIS POST AS DG, AND A NEWCOMER TAKING OVER AS DG (AS OF JANUARY 7), THE MINISTRY APPEARS TO

BE RUDDERLESS. THE SCANDALS OVERSHADOWED ANY CREDIT HIRCHSON GAINED FROM HIS STARTLING SUCCESS IN SECURING QUICK APPROVAL OF THE BUDGET. HE IS ATTEMPTING TO PROJECT A "BUSINESS AS USUAL" APPROACH, BUT MUCH DEPENDS ON THE ABILITY OF THE NEW DG YAROM ARIAV TO TAKE QUICK CONTROL AND RESTORE CONFIDENCE AMONG THE MINISTRY'S WORKERS. YOSSI BACHAR'S TAKING OVER THE ITA TEMPORARILY (AS OF JANUARY 7) WILL SERVE AS A CALMING INFLUENCE.

110. (C) COMMENT CONTINUED: THE OLMERT GOVERNMENT IS VERY WEAK, BUT IRONICALLY, THIS MAY BE ITS ONLY ADVANTAGE AT THE MOMENT IN ITS ABILITY TO ENFORCE ITS ECONOMIC POLICY. MANY OF THE MKS IN THE RULING COALITION REALIZE THAT THEY STAND TO LOSE THEIR SEATS SHOULD THERE BE EARLY ELECTIONS, HENCE THEIR AGREEMENT TO DROP THEIR TRADITIONAL EXORBITANT SPENDING DEMANDS IN ADVANCE OF THE BUDGET VOTE. HOWEVER, IF THE LABOR PARTY DOES DECIDE TO QUIT THE GOVERNMENT, IT WILL LEAVE OLMERT WITH 59 SEATS IN THE 120-SEAT KNESSET. THIS INCREASES THE LIKELIHOOD THAT HE WILL INVITE UNITED TORAH JUDAISM INTO THE COALITION AND MIGHT HAVE TO REINSTATE THE BUDGET-BUSTING LARGE FAMILY BONUSES TO SECURE THEIR SUPPORT. SINCE THE INITIATION OF THE ECONOMIC REFORM PROGRAM IN 2003, IT HAS BEEN THE LEADERSHIP AND THE PROFESSIONAL STAFF OF THE MINISTRY OF FINANCE THAT HAS STOOD FIRM AGAINST PREVIOUS ATTEMPTS TO INCREASE SPENDING RECKLESSLY. THE PRESENT RASH OF SCANDALS LEAVES THEM IN A POSITION THAT LIMITS THEIR INFLUENCE ON FISCAL POLICY. EVEN AT THE HEIGHT OF THE MOF'S INFLUENCE, IT WOULD NOT HAVE BEEN ABLE TO COMPLETELY PREVENT EXCESSIVE SPENDING RESULTING FROM A COALITION CRISIS. SHOULD UTJ ENTER THE GOVERNMENT AT A TIME WHEN THE MOF IS TOTALLY WITHOUT INFLUENCE, IT IS QUITE LIKELY THAT THE PRICE WOULD BE A BUSTING OF THE BUDGETARY FRAMEWORK THAT HAS HELD SINCE 2003 AND WAS RESPONSIBLE FOR ISRAEL'S TREMENDOUS ECONOMIC RECOVERY. END COMMENT.

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JONES